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ORIGINAL

July 8, 1996 [redacted]

Mr. William F. Caton
Secretary
Federal Communications Commission
Room 222
1919 M. St., N.W.
Washington, D.C. 20554

RECEIVED

JUL 8 1996

FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF SECRETARY

Re: Implementation of the Local Competition Provisions in the Telecommunications Act of 1996; CC Docket No. 96-98, DA-1007, IAD 96-175.

Dear Mr. Caton,

Enclosed herewith for filing are the original and four (4) copies of MCI Telecommunications Corporation's Comments regarding the above captioned matter.

Please acknowledge receipt by affixing an appropriate notation on the copy of the MCI Comments furnished for such purpose and remit same to the bearer.

Sincerely yours,

Mary L. Brown

Mary L. Brown

Enclosure
MLB

cc: Ms. Wanda Harris -- Room 518 (2 copies)
Chief, Industry Analysis Division, Common Carrier Bureau
Chief, Competition Division, Office of the General Counsel
ITS

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Summary

For six independent reasons, the Commission should conclude that the financial model it has released for comment in this docket may not service as a basis for decision or in any way influence the outcome of this pending rulemaking. The reasons are:

No provision of Sections 251 or 252 of the Telecommunications Act of 1996 permits the Commission to consider the alleged impact of interconnection requirements on ILEC earnings or stock prices. While the Congress did provide for consideration of economic impacts of applying Section 251 local competition rules on certain rural incumbent local exchange carriers in subsection (f), it made no similar provision for larger ILECs. Consideration of financial impacts for these larger ILECs is therefore arbitrary, since Congress can be presumed to have included consideration of economic effects on larger ILECs if it had so desired.

Any consideration of the purported future impact of an interconnection order on ILEC permits gaming of the regulatory process, since ILEC predictions of future stock performance could be easily influenced by present statements to market analysts. In addition, it would be inherently discriminatory to base a decision on stock impacts of one segment of the industry (ILECs) to the exclusion of other segments.

ILEC stocks are performing well, and there is no discernible trend of pro-competitive regulatory rulings doing any violence to stocks. As one analyst has

said, "How often is it that an industry wakes up one day, finds its addressable market expanded by 40% and can launch the new [long distance] service without noticeable dilution and achieve positive earnings by the second year?"

The model does not conform to statutory standards, by permitting consideration of ILEC rate of return despite the express language of the statute prohibiting the Commission from considering this in developing its rule on "cost" for 251(c)(2) and (3).

The model is inherently arbitrary and therefore is likely to produce misleading results --

- permits "prices" of services to be established without any reference to the "costs" of their inputs;

- fails to consider critical competitive variables, such as the implementation of reciprocal compensation and the manner in which a competitively-neutral Universal Service Fund will, in fact, be financed and administered under Section 254;

- does not consider, in determining the profitability of ILECs, a single dollar of the revenues they will gain from services other than wireline telephony, including the lucrative cellular revenues from the franchises they were given for free; and

- contains a number of flaws and mathematical errors that, among other mistakes, permits ILEC plant to be considered "stranded" even if it has not yet been built.

Even if the model were to be used (which it should not be), it would be essential that reasonable values be used in specifying its operation. Attached to these comments is a scenario that targets attention on the need to reduce access charges to cost. The scenario shows that ILECs are not financially damaged if access charges are simultaneously brought to cost in 1998.

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FEDERAL COMMUNICATIONS COMMISSION
Washington, DC 20554

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COMMENTS OF
MCI TELECOMMUNICATIONS CORPORATION

I. Introduction

In its rulemaking docket implementing Sections 251 and 252 of the Telecommunications Act of 1996,[1] the Commission has requested comments on a staff model that purports to model financial impacts on the telecommunications industry of a variety of regulatory and competitive events.[2] According to the Public Notice, the model purports to allow users to evaluate the "effects" and "relative impacts" of changes in input data on "traditional industry segments." For six independent reasons, the Commission should conclude that the financial model may not serve as a basis of a decision in this docket, nor influence in any way the outcome of the pending interconnection rulemaking.[3]

First, no provision of Sections 251 or 252 of the Telecommunications Act of 1996

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1 Telecommunications Act of 1996, Pub. L. No. 104-104, 110 Stat. 56. ("the Act").

2 Public Notice, "Supplemental Comment Period Designated for Local Competition Proceeding," CC Docket No. 96-98, DA-1007, released June 20, 1996.

3 Implementation of the Local Competition Provisions in the Telecommunications Act of 1996, CC Docket No. 96-98, FCC 96-182, released April 19, 1996.

permits the Commission to consider the alleged impact of interconnection requirements on the Regional Bell Operating Companies' (RBOCs') earnings or stock prices. That is because the essential purpose of these sections is to open the fortress-walls of monopoly to the fresh breeze of competition by requiring the incumbent local exchange carriers (ILECs) to gain their revenue the old-fashioned way: By earning it.

To be sure, the dawn of competition marks the end of ILEC guaranteed revenue streams. And, to be sure, ILECs, like all monopolists, will attempt to contend that important social interests will be sacrificed if they are subjected to the same competitive forces that have led other American industries to lead a worldwide revolution in quality, affordability, and productivity.

The simple point is this: Congress rejected monopolist entreaties when it wrote Sections 251 and 252. It would thus be entirely inconsistent with the Act for the FCC to reverse Congressional judgment by using financial predictions in even the slightest way in its consideration of the interconnection requirements at issue in CC Docket 96-98.

Second, any consideration of the purported future impact of an interconnection order on the ILECs would render the Commission's judgment inherently arbitrary. That is because the prediction of future stock market performance could be easily influenced by present statements to market analysts. Any ILEC knows that movements in the stock market are triggered by investors who compare yesterday's investment predictions to today's events. That means that if an ILEC can convince an investment analyst that it expects a very favorable result in the interconnection proceeding, it would simply have to return to the Commission with the warning that its stock prices would fall if the market's (inflated) expectations were dashed. This is gaming at its worst. Additional arbitrariness is introduced by the apparent emphasis in the model on RBOC stock and ILEC stock prices to the exclusion of stock prices of interexchange carriers (IXC) and other new entrants.

Third, RBOC stocks are performing well. Indeed, for several financial quarters the RBOC Industry Group stocks have matched or beaten the S&P 500 Index on a total return basis.[4] There is no discernible trend of pro-competitive regulatory rulings doing any violence to RBOC stocks. A variety of factors contribute to the current value of RBOC stocks, not one of which would be changed were the Commission to issue a pro-competitive order. For example, Wall Street analysts recognize that, regulatory requirements to one side, RBOCs will be able to enter long-distance markets with much greater speed and much less investment than is required of new entrants, like MCI, entering local markets -- thus providing ILECs with substantial opportunity to capture revenue that would off-set any "loss" in local markets, which would be offset in any event by increased demand as prices for local services decrease.[5] As one analyst has said, "How often is it that an industry wakes up one day, finds its addressable market expanded by 40% and can launch the new [long-distance] service without noticeable dilution and achieve positive earnings by the second year?"[6] Any review of financial impacts to ILECs of a decision in this docket would lead inexorably to the conclusion that ILEC stock prices and future revenue streams should be treated as irrelevant to the

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4 Charles Schelke, Telecommunications Service Companies - Outlook, Smith Barney; Telecommunications/Services, May 23, 1996 at 1.

5 The latter point is, of course, exactly what happened to AT&T in the long-distance market.

6 Daniel Reingold, Telecom Services -- RBOC & GTE, Merrill Lynch; Securities Research & Economics Group, May 14 1996 at 6.

interconnection proceeding.

Fourth, and even on its own terms, the model does not conform to statutory standards. For example, and as noted above, Section 252 expressly forbids the Commission from considering rate-of-return in determining the rates for interconnection and unbundled, network elements. But the model is expressly designed to consider the effects on ILEC rates of return of the various scenarios it is capable of evaluating. It is difficult to grasp how the Commission may rely on a model that rests on analysis that the Commission is expressly forbidden from using.

Fifth, and in any event, the model is inherently arbitrary and therefore is likely to produce misleading results. That is because the model, for example:

-- permits "prices" of services to be established without any reference to the "costs" of their inputs;

-- fails to consider critical competitive variables, such as the implementation of reciprocal compensation and the manner in which a competitively-neutral Universal Service Fund will, in fact, be financed and administered under Section 254;

-- does not consider, in determining the profitability of RBOCs and other ILECS, a single dollar of the revenues they will gain from services other than wireline telephony, including the lucrative cellular revenues from the franchises they were given for free: and

-- contains a number of flaws and mathematical errors that, among other mistakes, permits ILEC plant to be considered "stranded" even if it has not yet been built.

Sixth, even if the model were to be used (which it should not be), it would be essential that reasonable values be used in specifying its operation. The inherent circularity in the process of using a model to influence a regulatory outcome is, of course, demonstrated by the need to assume reasonable regulatory outcomes for the purpose of operating the model in the first instance. Attached to these comments is a scenario that targets attention on the need to reduce access charges to cost. Attachment B, which reduces access charges to cost by the year 1998, shows that RBOCs quickly rebound from lost revenue to end the decade strongly after suffering only very slightly negative short-term effects on their stock prices.

In sum, the use of the staff model is not permissible as part of the pending interconnection rulemaking. In this instance, the quest for more knowledge, made in good faith by a Commission undoubtedly interested in contemplating the likely effects of its rulings, nonetheless would violate the prime directive of the very statutory sections that must be implemented on or before August 8, 1996

II. The Commission Must Base its Interconnection Ruling on the Statutory Provisions Provided by Congress

A. Consideration of Financial Impacts on ILECs Is Inconsistent with the 1996 Act

No provision of Sections 251 and 252 of the Telecommunications Act of 1996 permits the Commission to consider the alleged impact of interconnection requirements on ILEC earnings or stock prices. Congress specifically rejected monopolist entreaties when it wrote the 1996 Act.

The language of Sections 251 and 252 make this conclusion abundantly clear. For example, the pricing provisions mandate:

-- the resale of telecommunications at wholesale rates (Section 251(c)(4)(A)), not at wholesale rates plus ILEC revenue insurance,

-- the creation of wholesale rates through a specific statutory formula (Section 252(d)(3)), which specifically excludes retail-related costs that are avoided in a wholesale environment.

-- the availability of interconnection and network elements at "cost (determined without reference to a rate-of-return or other rate-based proceeding)," which may include a "reasonable profit," (Section 252(d)(1)), but which notably fails to include any contribution for the continued extension of past, non-cost-based revenue streams,

-- that charges for transport and termination may include a "reasonable approximation of the additional costs of terminating such calls," but not an approximation of past revenue received

Indeed, while Section 251(f) specifically asks regulatory agencies to review the potential economic impact of competition on certain rural ILECs, the remaining subsections of 251 are silent on the question of financial consequences of local competition rules. As a matter of elementary statutory construction, one can presume that Congress would have asked the Commission to consider economic consequences on all ILECs if it had wanted financial impact to be a basis for agency decision-making. Where Congress enumerates exceptions to a statutory scheme, other exceptions will not be implied,[7] and where particular language is included in one provision of a statute but not in another, such language may not be implied where it has been omitted.[8]

Moreover, in implementing Section 251 of the 1996 Act, the Commission may not consider irrelevant factors. An agency rule is arbitrary and capricious "if the agency has relied on factors which Congress has not intended it to consider." Motor Vehicle Manufacturers Ass'n v. State Farm Mutual Automobile Ins. Co., 463 U.S. 29, 43 (1983). Generally, the only stated limitation on the obligations of Section 251 is "technical

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7 See, e.g., Andrus v. Glover Constr. Co., 446 U.S. 608, 617 (1980).

8 See, e.g., Russello v. United States, 464 U.S. 16, 23 (1983).

feasibility."[9] Accordingly, the Commission may not consider other possible limitations, such as economic burden, in implementing Section 251, since Congress has already determined that such considerations are irrelevant

For example, in American Textile Manufacturers Institute v. Donovan,[10] the Supreme Court held that where the governing statute directed the Secretary of Labor to regulate toxic materials "to the extent feasible," the Secretary was precluded from using any cost-benefit analysis in deciding how to set standards under the Act, explaining:

> Any standard based on a balancing of costs and benefits by the Secretary that strikes a different balance than that struck by Congress would be inconsistent with the command set forth in [the Act].[11]

Similarly, in Sierra Club v. EPA,[12] where the governing statute directed the EPA to "require ground water monitoring as necessary to detect contamination," the Court held that it was improper for the EPA to relieve certain small landfills from the monitoring requirement on the basis of practicability of compliance. The Court explained that the statute permitted only one factor to be considered -- whether monitoring was "necessary to detect contamination" -- and that the agency therefore could not consider other factors.[13]

Second, any consideration of the purported future impact of an interconnection

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9 See, e.g., Section 251(b)(2), 251(c)(2)(B), 251(c)(3).

10 452 U.S. 490 (1981).

11 Id. at 509.

12 992 F.2d 337 (D.C. Cir. 1993)(per curiam).

13 Id. at 344. See also, Farmworker Justice Fund, Inc. v. Brock, 811 F. 2d 613, 622 (D.C Cir.), vacated as moot, 817 F.2d 890 (1987)(where the governing statute prohibited the Secretary of Labor from promulgating certain regulations for farms with 10 or fewer workers, it was improper for the Secretary to consider that limited prohibition in deciding not to promulgate such regulations for farms of any size).

order on the ILECs would render the Commission's judgment inherently arbitrary. That is because the prediction of future stock-market performance could be easily influenced by present statements to market analysts. Any ILEC knows that movements in the stock market are triggered by investors who compare yesterday's investment predictions to today's events. That means that if an ILEC can convince an investment analyst that it expects a very favorable result in the interconnection proceeding, it would simply have to return to the Commission with the warning that its stock prices would fall if the market's (inflated) expectations were dashed. This is gaming at its worst.

Additional arbitrariness is introduced by the apparent emphasis on RBOC and incumbent local exchange carrier (ILEC) stock prices. It would be inherently discriminatory, of course, for the Commission to consider the impact of its rulings on ILEC, but not interexchange carrier (IXC), stock prices. The ILEC shareholders are not entitled to greater protection under the law than those who have purchased MCI stock. Indeed, IXC stock is much more likely to react with volatility than RBOC stocks -- a higher percentage of which are held by individual, rather than institutional, owners. However, consideration of all of the relevant telecommunications stocks would only make the Commission's task harder, not easier. For example, MCI's stock has declined by 8.98 percent since the issuance of the NPRM (during a time in which RBOC Industry Group stock price has declined 0.52 percent).[14] By what possible legally-reviewable means would the Commission unravel the movements of even a single IXC's stock prices to determine how much is due to past -- or its projected future -- regulatory actions? To set out on such a quest is to substitute a random walk in the financial markets for the

[14] Prices as of close of business July 5, 1996.

words of the law and the ample public policy expertise of the Commission.

B. RBOC Stock Prices Are Not Threatened By the Commission's Interconnection Proceeding

The RBOCs have attempted to persuade the Commission that national unbundling and interconnection rules allowing new entrants to compete effectively in local telecommunications markets will have a significant negative impact on the valuation of RBOC stock prices. The Commission should not speculate on, nor concern itself with, the potential impact of implementing the Act upon the valuation of RBOC stock. There exists no true risk of a significant drop in RBOC industry stock values for several reasons. First, the issuance of state and federal regulatory decisions historically have had a negligible impact on RBOC stock prices. Second, most major Wall Street firms forecast a profitable future for RBOC investors. Third, a review of how most investors evaluate stock performance demonstrates that the Commission's implementation of the Act should not significantly impact RBOC stock prices.

As is indicated by the table below, RBOC stock prices have appreciated, on average, by nearly 20 percent over the last year. In comparison, the S&P 500 increased 23 percent over the same period. The increase in RBOC stock prices is significant because during the last year many important regulatory events and decisions have occurred, yet RBOC stock prices continue to rise.

	June 30, 1996	June 30, 1995
AMT	59.375	44
BST	42	31.75
BA	63.75	56
NYX	47.5	40.25
PT	33.75	26.75
SBC	49.25	47.625
USW	32	28.625[15]
GTE	44.75	34.125

A closer examination of RBOC stock price sensitivity further demonstrates that RBOC stock prices exhibit little or no reaction to the issuance of key state and federal regulatory decisions. For example, on April 19 1996, the Commission released the Notice of Proposed Rulemaking in this docket. The RBOC Industry Group Stock Price increased by three percent between April 18 and April 20, 1996. Similarly, state decisions that clearly reduced an RBOC's immediate earnings appear to have had a negligible impact on the RBOC's stock price. For example, on April 11, 1996, the Washington Utilities and Transportation Commission (WUTC) issued an order reducing US West's revenues by $91 million a year (Docket UT-950200). US West's stock traded at the same price the day before and the day after the WUTC released its order. Attachment A details individual and RBOC Industry Group stock prices the day before, the day of, and the day after several significant state and federal regulatory decisions since the enactment of the Telecommunications Act.

Typically, RBOC stock prices are not significantly impacted by issuance of regulatory decisions. That is because RBOC stock values are based on a variety of factors (e.g., management practices, cash flow, etc.), of which regulatory decisions are

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15 US West Communications began trading at the end of October, 1995.

just one. Also, by the time a regulatory decision is rendered, Wall Street has generally anticipated and incorporated the effects of the decision. Only regulatory rulings that surprise Wall Street would be expected to have an impact on RBOC stock prices. Wall Street has had several months to analyze the Telecommunications Act of 1996, the Commission's Notice, and comments submitted by all parties. Any impact, positive or negative, has already been priced into the RBOC stock prices.

Moreover, Wall Street remains bullish on RBOC stock. The vast majority of Wall Street investment firms who have evaluated the RBOCs since April 19th continue to strongly recommend many RBOC stocks to investors. Some firms, notably Smith Barney and Merrill Lynch, recommend buying RBOC stocks in lieu of IXC stocks. Though most of these firms recognize the risks presented by Commission regulation, none mention this risk as a contributing factor in either an unfavorable or neutral stock valuation.

As the table below demonstrates, of the five firms surveyed, four (Merrill Lynch, Smith Barney, UBS Securities and AG Edwards) recommend RBOC stocks to their customers. While all of the firms recognized the potential for regulatory surprises, only Morgan Stanley dissuades investors from investing in RBOC stocks. However, Morgan bases its opinion upon the risks posed by impending true competition and not the risks posed by the Commission's proposed implementation of the Act.

Wall Street RBOC Investor Recommendations*

F = Favorable N = Neutral U = Unfavorable	AMT	BA	BST	GTE	NYX	PT	SBC	USW	ATT	MCI
AG Edwards	F	F	F	--	--	--	F	--	--	F
Merrill Lynch	F	--	F	F	--	F	F	F	N	N
Morgan Stanley	U	--	N	--	--	U	N	N	N	F
Smith Barney	F	F	F	F	F	F	F	N	N	N
UBS Securities	F	F	N	F	N	F	F	N	F	P

*As of July 8, 1996

To support their evaluations, the Wall Street analysts provide a variety of rationales:

-- The RBOCs will have an initial advantage over the IXCs because of the relatively minor capital expenditure necessary to enter the long distance market.

-- Though the RBOCs may lose their traditional status as safe stable stocks, the increased risk/reward potential of these stocks greatly outweighs any negative impacts.

-- The deep discounts available to RBOCs in the long distance market will offset any losses due to reduced revenue from local capacity.

-- The future performance of an RBOC stock depends more upon the individual company than any market segment influence such as Commission regulations.

While all the firms have advised investors of the risks posed by adverse Commission regulations, none of the firms consider this risk significant enough to alter RBOC investment ratings. UBS Securities and Smith Barney both advised their customers of the risks posed by regulatory surprises, but neither firm singles out any aspect of the Commission's Notice of Proposed Rule Making as providing a reason for concern. Therefore, the rules as proposed by the Commission are not viewed by Wall

Street as posing a danger to investors.

Merrill Lynch believes the "high incremental margins and low capital intensity of long distance enables the RBOCs and GTE to gain enough to offset the pain of losing . . comparable market share in the local telephone market."[16] Merrill views the RBOC entry into long distance as the "ultimate vertical service feature," increasing the typical RBOC addressable market by 40% net of access charges already collected. Merrill calls long distance the "ultimate" vertical service because with minimal capital investment it can be offered to existing customers. Customers need only be convinced to switch suppliers. Merrill concludes by asking "[h]ow often is it that an industry wakes up one day, finds its addressable market expanded by 40% and can launch the new service without noticeable dilution and achieve positive earnings by the second year?"[17]

In comparison Merrill is "cautious about most long distance LD stocks . . . [because] the RBOCs will likely gain FCC approval to offer LD to its region customers."[18] Any benefits gained by local competition will take time and capital, while the IXCs "will sell LD capacity to the RBOCs at far steeper discounts[19] (80% range) than

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16 Daniel Reingold, Telecom Services -- RBOC & GTE, Merrill Lynch; Securities Research & Economics Group. May 14, 1996, at 3.

17 *Id.* at 6.

18 Daniel Reingold, Telecom Services -- Long Distance, Merrill Lynch; Securities Research & Economics Group, May, 20, 1996 at cover page. MCI does not, of course, endorse this or any other analyst opinion.

19 On June 20th, Merrill Lynch released a report claiming the recent signing of the BellSouth/AT&T wholesale long distance contract reinforces their support for RBOC stock values. Merrill asserts the contract proves the RBOCs will be able to obtain extremely large discounts on long distance service (as much as 85% off retail, net of costs) and "thus can offer long distance service without the heavy up-front capital investment" characteristic of the phone business. Daniel Reingold, Telecom Services -- BLS/AT&T Contract Reinforces RBOC/GTE Invest. Case, Merrill Lynch; Securities Research & Economics Group, June 20, 1996.

they can buy wholesale local capacity (20%-35% range, by [Merrill's] estimates)."[20]

A typical investor will not churn his or her RBOC stock based upon speculation surrounding the release of a regulatory ruling. Instead the investor will generally take a long term view incorporating a few basic assumptions including:

- It will take the RBOC competitors a long time to enter the local markets and therefore the RBOC earnings will not be impacted very quickly.

- At least some RBOCs apparently intend to immediately file for long distance entry. Because investors know that the RBOC's cost of entry into long distance is much less than their competitors cost of entry into local, investors will think that the RBOCs will have a more immediate impact.

- The Commission order will lead to demand stimulation for local and long distance and increased local revenues for RBOC own services. Therefore investors will think that the RBOC's will benefit due to the purchase of more resold and unbundled local service and increase long distance revenues.

- RBOC stocks are "dividend supported" and the RBOCs have the ability to cover the dividend (by cutting costs or improving efficiency) even if they lose some profits from access charges or other impacts of the order. The RBOCs are also realizing strong cash flow from other ventures such as cellular and overseas ventures which can be used to offset any losses in the local market.

Investors will likely rely on company predictions regarding the Commission's interconnection ruling. All the factors discussed above will make it unlikely the ILECs can credibly claim that the Commission's interconnection order will lead to missed earnings expectations. The ILECs might make this prediction, but only to try to bring political pressure on the Commission (or the appellate body) to change the order.

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[20] Daniel Reingold, Telecom Services -- Long Distance, Merrill Lynch; Securities Research & Economics Group. May 20, 1996 at cover page.

C. The Proposed Model Is Inconsistent with the 1996 Act

The Telecommunications Act of 1996 requires that rates for interconnection and unbundled network elements shall be set based on the cost of providing interconnection or network elements, including a reasonable profit.[21] This being the case, the focus of the Commission's deliberations in this proceeding should be on determining the cost of interconnection and unbundled network elements. As MCI stated in its comments in response to the Notice of Proposed Rulemaking in this proceeding,[22] the Commission should establish presumptive rate ceilings for unbundled network elements based on the total service long run incremental cost ("TSLRIC") of each network element as estimated in the Hatfield Study. The model appears, however, to shift the focus away from costs, and toward a consideration of market outcomes given certain pricing decisions. Consideration of these factors is beyond the authority granted to the Commission by Congress in Sections 251 and 252 of the Act. Moreover, a Commission decision based on projected market impact is arbitrary and capricious, and not the basis on which good public policy should be formulated.

The Act is quite clear as to the standard to be employed in establishing rates for interconnection and for unbundled network elements. These rates are to be based on the cost of providing interconnection and unbundled network elements, and may include a reasonable profit. The standard does not empower the Commission to consider the effects on any particular industry segment or any particular group of customers. To the contrary, the standard expressly forbids the Commission from considering rate of return in

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21 See Section 252(d)(1).

22 MCI Telecommunications Corporation Comments, CC Docket 96-98, filed May 16, 1996.

determining the rates for interconnection and unbundled elements. Yet the model is expressly designed to consider the effects on ILEC rate of return of the various scenarios it is capable of evaluating. If the Commission cannot consider rate of return in establishing policy concerning interconnection rates, it is difficult to see the utility of a model designed to predict effects on ILEC rates of return.

Even if this model were capable of producing accurate and reliable results -- and for a number of reasons explained infra, MCI believes that it is not -- the Commission should refrain from setting policy to meet the goal of ensuring that no player in the market is harmed by the development of competition. Such a policy would be inimical to the development of a competitive marketplace. By attempting, for example to ensure that ILEC profits do not decline by setting rates for interconnection and unbundled elements at excessively high levels, the Commission either will prevent competitive entry, or will, by insulating the ILECs from the discipline of the market, support the market inefficiencies that otherwise would be competed away. In either case, consumers would be worse off than if the market were given a chance to enforce a transition to cost-based pricing in retail rates. By instead establishing a clear policy that rates for interconnection and unbundled network elements are set at cost, including a reasonable profit, the Commission will ensure that market forces will act to remove inefficiencies from the market and will ensure that consumers reap the full benefits of a competitive marketplace.

III. The Model Is Inherently Arbitrary and Generates Misleading Results

The telecommunications market is a complex one, involving interactions between hundreds of service providers and millions of consumers. The market is at the point of becoming much more complex, as markets previously controlled by monopoly service providers are opened to competition, and as the former monopoly service providers begin to enter markets that have been competitive. While the model considers a very large number of variables in attempting to predict the effect of various pricing and competitive entry scenarios on the profitability of industry segments, it is doubtful that even a model as complex as this one can fully capture the behavior of the market as hundreds of companies respond to hundreds of other companies' market activities.

MCI believes that the staff model will yield misleading results for the vast majority of cases considered, and is likely to produce accurate results over only a very small range of values that potentially may be entered as inputs to the model. Inaccuracies result from: 1) the lack of linkage in the model between certain key variables that will, in fact, be interdependent in the operation of the marketplace; 2) the model's failure to capture certain key factors in the development of competition for local exchange services; 3) the model's failure to consider certain key factors that will affect the profitability of both the ILEC and CLEC/IXC market segments; and 4) mathematical errors or flaws in the model's logic.

A. The Model Fails to Consider the Relationships Between Certain Key Input Variables

Perhaps the most serious shortcoming of the model is that certain variables that are interdependent in the actual operation of the market are specified in the model as independent variables. Among the "missing links" are the linkage between:

-- rates for toll services provided by IXCs to the ILECs for resale and the price charged by the ILECs in the retail market;

- -- the rates charged to CLECs for unbundled network elements and the retail rates that the CLECs may charge;
- -- the rates charged by the ILECs for retail interLATA toll services and the rate of penetration by the ILECs of the interLATA toll market; and
- -- the rates charged by the CLECs and the rate of penetration by the CLECs of the local exchange market.

In each of these cases, the fundamental relationship between the costs incurred by a producer and the price that producer may charge or the fundamental relationship between the price differential between competitors and the relative changes in market share among competitors is ignored by the model. The result is that it is possible to specify scenarios in the model that either could not or would not likely occur in the real market. In such cases, the results generated by the model are unreliable and misleading.

The relationship between cost and price is a fundamental one, and several inputs to the model affect this relationship. Specification number 36 in the model permits the user to specify the discount that will be provided by IXCs to ILECs on toll services purchased for resale, affecting the overall cost of the ILECs in providing interLATA toll services. This specification should, in turn, affect the price that the ILECs can charge in the retail market. If the ILEC cannot meet the market price without pricing below its cost, it is not likely to enter the market (absent a predatory pricing strategy). If the market price is above its total cost, then the margin between price and cost will determine the amount of discount from market rates that the ILEC is able to offer.

In the model, however, specifications number 47 and 49 permit the user to specify ***independently*** of the value entered for specification number 36 the amount of discount on toll rates that both ILECs and CLECs provide customers who elect to become "total bill" customers, i.e., those customers who elect to have the service provider provide local, intraLATA toll and interLATA toll services for them. The model thus violates the relationship between prices and costs. It would be possible for the user to specify a discount for ILEC prices that would result in a retail price below the ILECs' total cost of providing service.

Similarly, specifications 9-12 permit the user to specify the markup above incremental cost that will be charged for unbundled network elements, thus partly determining the cost that the CLECs will incur in providing service. Other specifications affecting CLEC costs are number 73 ("% CLEC loops provided with CLEC's own facilities"), number 104 ("Added monthly cost to provide billing/customer service"), and number 106 ("Add CLEC expense of adding or churning and unbundled loop incl. marketing). Again, the total cost of the CLEC will determine the price that the CLEC can charge and profitably enter the market. However, the model permits the user to enter at specification numbers 27, 28, and 29 the discount relative to ILEC rates that will be offered by CLECs ***independently*** of any of the specifications that affect CLEC total costs. The relationship between prices and costs once again is violated, and the user can enter a specification in the model resulting in a price for local service less than the CLECs' total cost in providing the service.

Another key relationship is the relationship between the relative retail prices charged by competitors offering comparable products and the change in relative market share among those competitors. All else being equal, one would expect that a competitor offering a lower price will gain market share at the expense of the other competitor(s), and, furthermore, that the rate at which the lower-price competitor gains market share is related to the differential between its rates and other competitors' rates. The lower the rate offered by a competitor, the faster the rate at which customers will migrate to that competitor. However, the model does not determine changes in market share for ILECs or CLECs based on the rates charged by any competitor in either the long distance or local markets. Specifications 79 and 80 permit the user to specify the percent of all customers that become ILEC "total bill" customers ***independently*** of the rate charged by the ILEC and of the relationship between ILEC prices and IXC prices for interLATA toll services. Specifications 77 and 78 permit the user to specify the IXC share of intraLATA toll for those customers electing to have different carriers provide their local and toll services ***independently*** of the rates charged by IXCs for intraLATA toll and of the relationship between IXC intraLATA toll rates and ILEC intraLATA toll rates. And specifications 68 and 69 permit the user to specify the percent of all loops provided by CLECs ***independently*** of the rate charged by the CLEC for local services and of the relationship between CLEC rates and ILEC rates. The relationship between rates and changes in relative market share that exists in real markets does not exist in the model, and the user could specify inputs that would result in a dramatic increase in CLEC market share in spite of a CLEC rate substantially above that of the ILEC.

For these reasons, great care must be exercised in specifying the inputs to the model. The user of the model must ensure that each of the several inputs that have a real relationship to each other in the operation of the real-world market are specified in a coordinated way. If the user specifies a high value for the markup over incremental cost charged to CLECs for unbundled network elements, he or she also should take care that the rate of CLEC entry into the local market and that the discount specified from ILEC